DEPARTMENT OF STATE REVENUE
Letter of Findings: 98-0717
Adjusted Gross Income Tax
For the Years 1990 through 1996

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ISSUES

I. Classification of Taxpayer's Partnership Income as Allocable – Adjusted Gross Income Tax.

Authority: IC 6-3-2-2(p); Allied-Signal Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992); Container corp. v. Franchise Tax Board, 463 U.S. 159 (1983); F.W. Woolworth v. Taxation and Revenue Dep't. of New Mexico, 458 U.S. 354 (1982); ASARCO, Inc. v. Idaho State Tax Comm'n., 458 U.S. 307 (1982); Exxon Corp. v. Dep't. of Revenue of Wisconsin, 447 U.S. 207 (1982); Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980); 45 IAC 3.1-1-153(b); 45 IAC 3.1-1-153(c).

Taxpayer argues that the audit erred when it determined that taxpayer's partnership income should be wholly attributed to the partnership's home state location and that, as a result, taxpayer did not qualify for unitary treatment in calculating taxpayer's adjusted gross income.

II. Abatement of the Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-5-1(b); IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer requests the Department to exercise its discretionary authority to abate the ten-percent negligence penalty. Taxpayer maintains that its failure to pay the full amount of its taxes was due to reasonable cause and not to willful neglect.

STATEMENT OF FACTS

Taxpayer manufactures chemicals which are used by its customers to produce products such as upholstery foam, industrial solvents, and resins for automobile parts. The taxpayer has no office or production facilities in the state. Rather, the taxpayer maintains rented storage facilities within Indiana from which it distributes various of its chemical products.

An audit of taxpayer's records resulted in an adjustment deducting partnership losses from the taxpayer's adjusted gross income. The taxpayer disagreed and submitted a protest to the Department of Revenue. The taxpayer declined the opportunity to conduct an administrative hearing on the protested tax issue. Instead, this Letter of Findings was prepared on the basis of information contained within the audit file and from supplementary information prepared by the taxpayer.

DISCUSSION

Taxpayer, along with two other entities, owns an out-of-state holding company partnership. Taxpayer owns 50 percent of the holding company partnership. The holding company partnership has no employees and is simply in the business of constructing, equipping, owning, and leasing an out-of-state chemical plant. By means of the parties' agreement, taxpayer actually operates the chemical plant – producing chemical products, conducting research, arranging sales – as if the plant were the taxpayer's own.

Pursuant to the parties' operating agreement, taxpayer makes lease payments to the holding company partnership. All of the various products produced at the chemical plant are then "distributed" to the three parties which own the holding company partnership.

The audit found that the lease agreement was made at "arm's-length" – meaning that the lease payments made to the holding company partnership fairly reflected the value taxpayer received for the right to possess and operate the chemical plant. The lease payments were not simply a "token" payment creating an underlying or secondary fiduciary relationship between taxpayer and the holding company partnership.

The taxpayer argues that it has a unitary relationship with the holding company partnership. Whether or not there is a unitary relationship between taxpayer and the holding company is significant because of the holding company partnership's "income" during the years at issue. Although the holding company partnership received actual income in the form of lease payments, it also was able to take advantage of the depreciation attributable to the chemical plant and the equipment contained within the plant. The holding company partnership's losses during the audit period were attributable to the federal depreciation of the plant assets being greater than the book depreciation.

The audit determined that there was no unitary relationship and that the holding company partnership's "income" was entirely attributable to the partnership's home state under 45 IAC 3.1-1-153(c). Taxpayer maintains that there is a unitary relationship and that, as a result, the partnership's "income" should be apportioned. By this means, taxpayer wishes to take advantage of the partnership's losses in arriving at the taxpayer's Indiana adjusted gross income.

45 IAC 3.1-1-153(b) determines whether or not a unitary relationship exists between a taxpayer and its corporate partner. In part, the regulation states that if a "corporate partner's activities and partnership's activities constitute a unitary business under established standards, disregarding ownership requirements, the business income of the unitary business attributable to Indiana shall be determined by a three (3) factor formula . . . ." Taxpayer must demonstrate that the

relationship between itself and the holding company partnership exhibits the characteristics of a unitary relationship.

The Supreme Court has developed a three-part test to determine the existence of a unitary relationship; common ownership, common management, and common use or operation. Allied-Signal Inc. v. Director, Div. of Taxation, 504 U.S. 768 (1992); F.W. Woolworth v. Taxation and Revenue Dep't. of New Mexico, 458 U.S. 354 (1982); ASARCO, Inc. v. Idaho State Tax Comm'n., 458 U.S. 307 (1982); Exxon Corp. v. Dep't. of Revenue of Wisconsin, 447 U.S. 207 (1982); Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980).

45 IAC 3.1-1-153(b) gives no indication of the precise degree of ownership required to demonstrate common ownership. However, the record indicates that taxpayer owns 50 percent of the holding company partnership. Therefore, the evidence establishes a significant amount of common ownership between the parties.

The second relevant criteria is that of common management. Common management is demonstrated when the parent company provides a management role that is "grounded in [the parent company's] own operational expertise and its overall operational strategy." Container corp. v. Franchise Tax Board, 463 U.S. 159, 180, n.19 (1983). Taxpayer argues that – in practical effect – it exercises almost total managerial control over the chemical plant and over all the activities conducted within the chemical plant. However, the issue is whether or not taxpayer exercises managerial control over the holding company partnership. Taxpayer is in the business of manufacturing and selling chemical products. The holding company partnership is in the business of owning and leasing a chemical plant. There is little or no indication that taxpayer exercises managerial control over the holding company partnership and its specialized leasing operation. There is nothing to indicate what decisions were made by the holding company partnership or what degree of involvement taxpayer – as a chemical manufacturer – has in the day-to-day operation of the holding company partnership's leasing business.

The third relevant criteria is that of common operation or use. There is no question that taxpayer operates and uses the chemical plant. However, there is little or no substantive information regarding the degree to which taxpayer either operates or uses the holding company partnership.

Regardless of the relevance of the three criteria and to what degree taxpayer can demonstrates its compliance with those criteria, taxpayer is entitled to a consideration of whether requiring taxpayer to employ the standard apportionment formula accurately portrays taxpayer's Indiana adjusted gross income or whether, by doing so, taxpayer's Indiana income is distorted. IC 6-3-2-2(p). Taxpayer makes much of the audit's determination that the lease agreement between itself and the holding company partnership was at "arm's length" arguing that it could not "find any legal support that requires a non arms length transaction to qualify this business as unitary." Taxpayer is correct in maintaining that there is no specific statutory or regulatory language requiring that a non-arm's length transaction be demonstrated in order to qualify for unitary treatment. However, a non-arm's length transaction – one in which the lease transaction is secured by a "token" payment – gives evidence that unitary treatment of the parties is necessary to avoid distorting taxpayer's Indiana adjusted gross income. If the taxpayer was merely paying $1 to the holding company partnership for the privilege of using the chemical plant, then it

would be necessary to treat the holding company partnership and taxpayer as a single entity in arriving at a rational calculation of the taxpayer's income. The information indicates that taxpayer is paying fair market value to the holding company partnership.

Other than the fact that taxpayer owns a significant portion of the holding company partnership, there is no reason that taxpayer and the holding company partnership should not be treated as entirely distinct entities for purposes of determining taxpayer's Indiana adjusted gross income. There is little or nothing to indicate that, in the absence of unitary treatment, taxpayer's Indiana adjusted gross income would be distorted by simply ignoring the holding company partnership and treating taxpayer as an entirely independent entity.

FINDING

Taxpayer's protest is respectfully denied.

II. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer requests that the department exercise its discretion to abate the ten-percent negligence penalty imposed at the time of the original audit.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Under IC 6-8.1-5-1(b), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." The assessment – including the negligence penalty – is presumptively valid. The taxpayer has done nothing more than recite the regulatory language to the effect that is failure to pay the tax was due "to reasonable cause and not due to willful neglect."

FINDING

Taxpayer's protest is respectfully denied.

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